THE CITY OF SAN DIEGO

REPORT TO THE CITY COUNCIL

DATE ISSUED: May 30, 2007 REPORT NO: 07-095

ATTENTION: Council President and City Council
June 4, 2007

SUBJECT: Fiscal Year 2008 Tax and Revenue Anticipation Note

REQUESTED ACTION(S):

Authorize the execution of the Fiscal Year 2008 Tax and Revenue Anticipation Note (FY 2008 TRAN) financing in an amount not to exceed $130.0 million and the related financing documents to fund the projected seasonal cash flow deficit of the City's General Fund in Fiscal Year 2008. The related financing documents include a Note Purchase Agreement between the City and Bank of America, N.A. and an Accompanying Document to the Financing Resolution.

Authorize the Financial Advisory Services Agreement between the City and Montague DeRose and Associates, LLC to provide financial advisory services for the FY 2008 TRAN for an amount not to exceed $40,000, plus reasonable out-of-pocket expenses not to exceed $5,000. Also, authorize the City Attorney to enter into an agreement with Stradling Yocca Carlson & Rauth to provide bond counsel services for the FY 2008 TRAN in a fixed amount totaling $30,000, including out of pocket expenses.

STAFF RECOMMENDATION: Approve the requested actions.

SUMMARY:

I. BACKGROUND

Tax and Revenue Anticipation Notes ("TRANs") borrowing is a standard tool accessed by state and local governments to address temporary shortfalls arising from the fluctuations in annual tax or revenue receipts that the General Fund is dependent on to meet monthly cash flow needs during the fiscal year. The California Government Code (Article 7.6, Chapter 4, Part 1, Division 2, Title 5) and City Charter Section 92 specifically authorize the City to issue short-term notes in any fiscal year in anticipation of the collection of taxes and revenues of such fiscal year. A TRANs issuance is authorized by the legislative body of the issuer through the adoption of a resolution (the "Financing Resolution"), and is a general obligation of the issuer, payable from unrestricted taxes, income, revenue, cash receipts, and other monies of the entity attributable to the upcoming fiscal year. The issuer is not authorized to levy or collect any additional tax for the repayment of the TRANs.

The City has issued TRANs every year since Fiscal Year 1968 (except Fiscal Year 1979) to finance the General Fund cash flow needs of the City in anticipation of the receipt of property tax revenues from the County in December and April of each year. TRANs are generally sold in late June so that funds are available for General Fund disbursements that must be made commencing on July 1 of each year. Historically, the City has closed its TRANs financings on or around July 1 in order to be able to meet the pension Annual Required Contribution ("ARC") due at the beginning of the fiscal year.

A TRANs issuance is typically structured as a 12 month or 13 month obligation on a tax exempt basis, either as a public or private offering, in either a variable or fixed rate mode. The amount of borrowing is based on the General Fund's projected cash flow deficit in the upcoming fiscal year. Pursuant to Internal Revenue Service ("IRS") regulations, the size of the borrowing cannot exceed the projected deficit as certified by the City's Chief Financial Officer and Treasurer. The funds are borrowed upfront and repaid at maturity. Also as permitted under IRS regulations, any funds not immediately spent by the City are typically invested in taxable securities which generally yield a higher interest rate than the tax exempt borrowing rate on the TRANs issuance. Likewise, revenues required to be set aside under the terms and conditions set forth in the financing documents for a TRANs issuance to pay off the principal and interest at maturity can also be invested in higher yielding securities than the borrowing rate to maximize the interest earned. The cumulative interest earnings from: (1) the portion of the borrowing not immediately spent down, and (2) the repayment amounts set aside (the "Set Aside Amounts") to pay principal at maturity will help offset the overall interest expense on the borrowing and benefit the City by lowering the overall cost of the borrowing.

For Fiscal Year 2008 (as has been the case for Fiscal Years 2005 through 2007), due to the unavailability of current audited financial statements, the City's FY 08 TRAN borrowing has been structured as a private placement. Based on the City's FY 08 projected cash flow needs, the borrowing rate, and the projected earnings rate on the Set Aside Amounts[1] it was determined that borrowing the full TRAN amount, currently projected to be $116 million, upfront would be financially advantageous.

II. DISCUSSION

Private Placement Structure and Financing Terms

A. Method of Sale

Under the proposed structure, the FY 2008 TRAN offering would be privately placed with Bank of America N.A. (BofA), a subsidiary of Bank of America Corporation. No disclosure document, or official statement, would be required or provided. The Securities and Exchange Commission (SEC) rules that require an underwriter to receive a disclosure document from the City would not apply to the proposed structure because the issuance would be a private placement to one buyer and not to the general public. BofA would be required to represent,

[1] While the security for the FY 08 TRAN would be the City's General Fund, as contemplated in the financing documents, the City expects to set aside funds for the repayment of the note from its FY 2008 property tax receipts.

among other things, that it: (1) has sufficient knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment in the FY 08 TRAN; (2) has been supplied with or been given access to information that it deems necessary to make an informed investment decision; (3) is purchasing the FY 08 TRAN for its own account, and not with a view to resell the investment; (4) acknowledges that there are restrictions on the transfer of the FY 08 TRAN; and (5) understands that City is not current with its financial statements.

As stated above, there would be no private or public offering circular containing City disclosure for this transaction. In order to conduct its credit due diligence, certain unaudited financial information, with the Disclosure Practices Working Group ("DPWG") review and input, is being provided to BofA with necessary disclaimers and limitations placed on the firm pertaining to the information provided. The resale restrictions placed on the transaction would specify that the FY 08 TRAN may not be syndicated, participated out, or transferred, unless the City selects the Bond Buyer One-Year Note Index pricing option (as described under Section II.B., below), in which case BofA could sell the FY 08 TRAN to a related trust, which in turn could sell certificates in such trust made up of no more than twelve qualified institutional buyers.

B. Pricing Structure of Notes

Upon the City Council approval of the financing, the City will enter into a Note Purchase Agreement ("NPA") with BofA, pursuant to which BofA would agree to purchase the FY 08 TRAN from the City. The loan would be structured on a fixed rate basis, and would have a maturity of 13 months (August 1, 2008), which would enable the City to maximize its earnings capacity on the borrowed funds in order to off-set the FY 08 TRAN borrowing cost. The City would have the ability to prepay without penalty.

The NPA specifies that the City would be able to select one of two pricing alternatives. The first alternative is based on BofA's 13 Month Cost of Funds Rate, which is the bank's cost of borrowing for a 13 month period. Because the bank borrows in the LIBOR[2] market, BofA's 13 Month Cost of Funds Rate should be very close to the 1-Year LIBOR rate. If the City chooses this option, the pricing would equate to 62.347% of the 13-Month Cost of Funds Rate plus 50 basis points (0.50%). The second alternative is based on the Bond Buyer One Year Note Index. (The Bond Buyer One-Year Note Index is a one-year note issue based on an unweighted average of estimated yields from ten major state and local issuers across the country.) Under this option, the pricing would equate to the Bond Buyer One-Year Note Index plus 45 basis points (0.45%). Both LIBOR and the Bond Buyer One-Year Note Index are commonly used indices for TRANs borrowings. The City will monitor the two indices and price its FY 08 TRAN based on the formula that is expected to result in the lower interest rate at the time of the execution of the NPA.

One significant advantage of the 13 Month Cost of Funds Rate option is the ability to adjust the interest rate spread if the City's underlying credit rating receives an upgrade during the term of the FY 08 TRAN. Specifically, while the note is outstanding, if the City's General Obligation

[2] LIBOR is the London Interbank Offered Rate. The 1-Year LIBOR Index is based on rates that contributor banks in London offer each other for inter-bank deposits.

bond rating improves, the spread over the 62.347% of the 13 Month Cost of Funds Rate (as established on the date the FY 08 TRAN is initially priced) would drop from 50 basis points to 43 or 45 basis points (0.43 or 0.45%), depending on the magnitude of the rating improvement. The adjusted interest rate would be effective from the day after the ratings action is announced through the remaining term of the Note. In the event of a rating deterioration or additional suspension of ratings, there would be no penalty, and the existing rate would remain in place. This feature will be taken into account in determining which option provides the lowest cost of borrowing.

The effective interest rate on the borrowing is estimated to be 3.83%,[3] based on interest rates as of May 7, 2007. The interest rate will be fixed at the time of the pricing of the FY 08 TRAN. Interest will be paid in two installments, with the first interest payment due on June 27, 2008 and reflecting accrued interest on the FY 08 TRAN as of that date, and the second and final interest payment due, along with the note principal, at maturity (August 1, 2008). Due to the fact that TRANs borrowings typically occur in June, as of the date of this report, there is no public offering TRANs data available for comparison purposes; however, should any data become available by the time the financing is presented to the City Council, staff will include such information in its presentation.

C. Up Front Borrowing

As with the TRANs issued for Fiscal Year 2007, and as is typical of TRAN borrowing undertaken by other local governments and consistent with tax law, the City would draw the entire loan upfront for the full 13-month term, rather than borrow the funds on an as needed basis under a Line of Credit. Given current market conditions, it is economically advantageous to the City to borrow the full amount upfront and reinvest any unutilized proceeds, reducing the net borrowing cost to the City. Historically, proceeds from TRANs have been reinvested by the City's Investments Division staff to maximize earnings on the reinvestment of those proceeds and the corresponding Set Aside Amounts. Based on interest rates as of May 7, 2007, the borrowing rate on the FY 2008 TRAN is expected to be 3.83%, while the expected investment earnings is 4.75%.

The following table provides an example to illustrate the net borrowing cost to the City.

	Net Borrowing Cost
Projected Borrowing Amount	$116,000,000
Projected Borrowing Rate	3.83%
Projected Gross Interest Expense (A)	**$4,887,080**
Projected Interest Earnings Rate	4.75%*
Projected Interest Earnings (B)	**$2,555,012**
Projected Net Borrowing Cost to City (A-B)	**$2,332,068**

* Estimated average interest earnings rate over the term of the note

**Including estimated costs of issuance of $105,000 (see page 7), the estimated net borrowing cost is $2.44 million

[3] Projected borrowing rate is based on the 13-Month Cost of Funds Rate option.

D. <u>Size of Borrowing</u>

The City currently expects to borrow $116.0 million on July 2, 2007. This is based on the maximum deficit projected for Fiscal Year 2008 as indicated by the projected monthly cash flow schedule (see Attachment 1). The cash flow schedule is based on the Fiscal Year 2008 Proposed Budget, as well as certain potential items to be included in the Mayor's May Budget Revision. The $130.0 million not-to-exceed amount recommended for authorization by the City Council is higher than the expected borrowing amount to provide a cushion in the event the need for additional borrowing is identified between the date of this report and the date the borrowing is executed (July 2, 2007). For example, the cash flow schedule could be impacted if there are additional items identified and included in the Mayor's May Budget Revision, changes related to City Council budget deliberations, and/or changes resulting from the Fourth Quarter Budget Monitoring. This not-to-exceed amount is well below the legal limit set by Section 92 of the City Charter, which limits the total amount of the TRAN borrowing issued in any fiscal year to an amount, in the aggregate, not more than twenty-five (25) percent of the City's total budgeted appropriations for such fiscal year (which is approximately $276 million based on the Fiscal Year 2008 Proposed Budget).

The FY 2008 TRAN will be secured by a pledge of the taxes and revenues to be collected in Fiscal Year 2008. The FY 2008 TRAN structure requires that specified portions of the property taxes be set aside on specific dates during the fiscal year for the repayment of the loan.

Financing Team

The engagement of BofA as the lender for this transaction was made through a competitive process. A Request for Proposals ("RFP") was issued on March 26, 2007 to solicit proposals from financial institutions to execute a direct purchase of the FY 08 TRAN. The City received five responses, and BofA was selected for submitting the lowest bid and offering the most flexible structuring options. For additional detail on the bids submitted, Attachment 2 provides a bid summary sheet.

Pursuant to Council Policy 900-09, BofA has submitted Community Reinvestment Activities ("CRA") of its community banking operations in the San Diego region. Specific information related to CRA is provided to the City Council under separate cover.

Montague DeRose and Associates, LLC ("MDA") was identified to provide financial advisory services in support of the FY 2008 TRAN from an as-needed list of financial advisory firms generated by a request for proposals process. MDA's fee for this issuance will not exceed $40,000 plus $5,000 for reasonable out of pocket expenses. The City Attorney's Office has identified Stradling Yocca Carlson and Rauth ("Stradling") to serve as bond counsel for a fixed fee totaling $30,000, including out of pocket expenses.

Financing Documents

The Financing Resolution and documents that would be approved through the requested actions are described below:

A. **Financing Resolution** – The Financing Resolution authorizes the issuance of the FY 08 TRAN, the approval of the Financing Documents (as described below), and any other actions of the Mayor and his designees that may be necessary to execute the FY 08 TRAN.

B. **The Financing Documents** – The financing documents include the Accompanying Document to the Financing Resolution and the NPA.

   1. Accompanying Document to the Resolution – The Accompanying Document to the Resolution presents all the supporting documents for the Fiscal Year 2008 TRAN financing, including the Cash Flow Deficit Report. It also includes information regarding the amount and term of the FY 2008 TRAN Note, the use of note proceeds, and the nature of the security for the note. In addition, it sets forth the transfer restrictions pertaining to the note.

   2. Note Purchase Agreement (NPA)– The NPA is an agreement between the City and BofA, pursuant to which BofA agrees to purchase the FY 08 TRAN from the City, and the City agrees to deliver it to BofA. The agreement details the representations, warranties, and agreements of the City and BofA in connection with the transaction.

Transaction Time Line

May 11, 2007	City's Disclosure Practices Working Group performed disclosure assessment
June 4/5, 2007	City Council approval of financing documents via Resolution
Week of June 18, 2007	BofA performs bring down due diligence
Week of June 25, 2007	Pricing of the FY 2008 TRAN (interest rate setting and signing of the NPA)
July 2, 2007	FY 2008 TRAN closing and receipt of note proceeds

III. FISCAL CONSIDERATIONS

As determined by the Fiscal Year 2008 Projected Cash Flow Deficit Report, the City expects to draw $116.0 million on July 2, 2007 from the BofA loan facility. Based on the estimated effective rate of borrowing of 3.83%, the gross interest payments on the loan are estimated to be approximately $4.89 million. The Set Aside Amounts to repay the FY 08 TRAN will be invested until the final maturity of the note (August 1, 2008); these interest earnings are estimated to total approximately $2.56 million (based on an assumed rate of return of 4.75%). The net interest cost of this borrowing (net of investment earnings and costs of issuance expense) is expected to be approximately $2.44 million.

The fees related to consultants for this transaction will be paid from the Tax Anticipation Notes Revolving Fund (Fund No. 65013). These fees include (i) bond counsel fees totaling $30,000, including expenses; (ii) financial advisory services in an amount not to exceed $45,000, including expenses; and (iii) BofA counsel fees totaling $30,000. The total amount included in the Fiscal Year 2008 Proposed Tax Anticipation Notes Budget for costs of issuance expenses is $105,000.

IV. ALTERNATIVES

Do not approve the requested actions necessary to issue the FY 08 TRAN. This is not recommended because the FY 08 TRAN is necessary to fund the seasonal cash flow deficit of the City's General Fund in Fiscal Year 2008.

V. PREVIOUS COUNCIL and/or COMMITTEE ACTION

The City has annually issued TRANs to fund the General Fund seasonal cash flow deficit.

VI. COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS

None.

VII. KEY STAKEHOLDERS AND PROJECTED IMPACTS

Business entities involved in this transaction include Bank of America, N.A., a subsidiary of Bank of America Corporation (Purchaser/Lender); White & Case, LLP (BofA's counsel); Stradling Yocca Carlson & Rauth (bond counsel); and Montague DeRose and Associates, LLC (financial advisor).

Lakshmi Kommi	Jay M. Goldstone
Debt Management Director	Chief Financial Officer

Attachment(s): 1. Fiscal Year 2008 Projected Monthly Cash Flow Schedule
2. FY 2008 TRAN – Bid Sheet Summary